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STATE FOR WHA/BSC, WHA/EPSC
STATE PASS USTR FOR KATE DUCKWORTH
STATE PASS FED BOARD OF GOVERNORS FOR ROBITAILLE
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STATE PASS OPIC FOR DEMROSE, NRIVERA, CMERVENNE
NSC FOR TOMASULO
TREASURY FOR JHOEK
USDOC FOR 4332/ITA/MAC/WH/OLAC
UDSOC ALSO FOR 3134/USFCS

E.O. 12958: N/A
TAGS: ECON EFIN PREL BR
SUBJECT: LULA'S PLAN TO RECOVER CPMF REVENUES AS EXPECTED
BUT NOT WITHOUT OPPOSITION

REF: A. SAO PAULO 1005
¶B. SAO PAULO 0832

¶1. (SBU) SUMMARY: The Brazilian government announced on January 2 three ways for compensating for lost revenues after losing the battle to renew the Provisional Financial Transactions Tax (CPMF) in December. As expected, the GOB announced a mix of tax hikes and potential cuts in government spending to cover the shortfall from the lost CPMF revenue (R$40 billion or approximately USD 23 billion at the current exchange rate). While the tax hikes have been announced in the form of increases to another financial transactions tax, the IOF (Financial Operations Tax), and increases in the CSLL (Corporate Profits Tax), the GOB is holding off on defining cuts in spending until February when Congress reviews the 2008 budget. The tax hikes are not expected to hurt Brazil's prospects for strong economic growth in 2008, but might hit some consumers harder than others and has the potential to slow the exploding growth in credit. The political opposition is attacking the Lula Administration for backtracking on its December promise not to raise taxes by specifically calling into question the constitutionality of the two tax hikes and by threatening to stop negotiating comprehensive tax reform. One potentially positive impact of the increase in the IOF tax is a likely slowing of credit growth, which would alleviate some of the Brazilian Central Bank's fears of growing inflation. As for spending cuts, Post is not convinced the GOB will follow-through on all the spending cuts, nor would these cuts be necessary. The forecast for robust economic growth in 2008 will likely mean higher tax receipts. In addition, it appears that the GOB has underestimated the additional revenues it will receive from increasing the IOF tax. END SUMMARY.

¶2. (U) On January 2, Finance Minister Guido Mantega and Planning Minister Paulo Bernardo announced three measures aimed to partly compensate for the revenue losses from the end of the Provisional Financial Transactions tax (CPMF) in December (Ref A). The R$30 billion package is in line with market expectations, and includes R$20 billion in spending cuts and R$10 billion in tax hikes on two taxes, the Financial Operations Tax (IOF) and the Tax on Corporate Net Profits (CSLL). (Note: Technically speaking, the spending cuts the GOB plans to make are reductions in expenditure growth; the GOB's overall spending is still expected to be higher in 2008 than 2007. Other economic contacts indicate that these taxes will generate significantly more than R$10 billion. End Note.) As an explanation for raising the IOF tax, Mantega stated that increases in the IOF would slow down the rate of credit growth and provide a small hedge against inflation. (Note: The overall credit market in Brazil grew by some 25 percent in 2007 and individual credit grew by more than 32 percent. End Note.) Concerning cuts to government spending, Minister Mantega again reaffirmed that the GOB will not make cuts to Bolsa Familia and to the Program for Growth Acceleration (PAC) without specifying which programs would receive spending cuts.

IOF-Financial Operations Tax Increased
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¶3. (U) The GOB issued a decree effective January 4 to increase the IOF which is a tax on a variety of financial transactions including credit, foreign exchange, and insurance and stock purchases. The decree increases the IOF by a fixed 0.38 percent on all financial operations



previously taxed under the CPMF (currency exchange operations for exports, foreign exchange from service revenues, goods and services and spending abroad using credit cards). In addition to the 0.38 percent, the GOB doubled the rate applied to personal credit transactions to approximately three percent per year or 0.0082 percent calculated on a daily basis. Originally the IOF accounted for about 1.3 percent of federal revenues (approximately R$8 billion). The IOF is not applied to foreign portfolio investments; however, repatriation of profits by Brazilian firms abroad is subject to IOF, as well as foreign direct investment in Brazil. Personal mortgages continue exempt from IOF, but mortgages for investment properties are subject to the three percent plus 0.38 percent surcharge.

¶4. (U) Under the decree, corporations pay IOF on more financial transactions including 0.38 percent on operations involving the export of goods and services and the import of services. Furthermore, the government created a specific tax rate for imported products that the GOB suspects have an unfair advantage in the domestic market, such as textiles, machine parts, and apparel, among others. The GOB also expanded the breadth of financial transactions covered by the IOF (adding an additional fixed 0.38 percentage point increase to the 1.5 percent levied) on corporate credit transactions to include the Brazilian development bank (BNDES) loans, financing for machinery and equipment, loans for rural exporters and rural producers, and on government transfers and financing of employment generation programs.

Corporate Profits Tax Increased
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¶5. (SBU) The GOB also notified Congress of a provisional measure to increase the CSLL from nine percent to 15 percent for financial institutions, which the GOB estimates would bring in an additional R$2 billion. Minister Mantega said that GOB chose financial institutions (including investment banks, finance companies, mortgage associations, credit card companies, leasing companies, stock markets, and insurance and capitalization companies) over other industries because the banking sector is the most profitable sector in Brazil.

The GOB must wait 90 days to begin collecting the additional tax, and Congress has 120 days to vote on the bill. Vice-President of Economic Research at Itau Corretora Mauricio Oreng told Econoff that Brazilian banks should be able to absorb the additional tax because the banking industry was extremely profitable in 2007. Several economic interlocutors, however, say that banks would likely pass on the increase to consumers rather than lower their profits.

## Effect on Companies and the Economy

¶6. (SBU) Overall, economic interlocutors told Econoff that they don't believe the tax hike will have a significant negative impact on economic growth. Oreng said he expects GDP growth above five percent unless the Brazilian Central Bank raises interest rates, which he sees as a growing possibility due to creeping inflation. Although the IOF increases are designed to replace the previous CPMF tax, many industries are still better off than under CPMF, according to local financial analysts. Industries with long production chains felt the largest impact under the CPMF tax (Ref A) because of its cascading effect on all stages of production. The IOF, on the other hand, is less of a drain on the



competitiveness of these industries because the tax is applied to a smaller base of transactions.

¶7. (SBU) Individuals, however, are likely to feel the IOF hit their wallets more heavily than CPMF did. Credit card interest rates will be three percentage points higher and if banks are able to pass on the CSLL to consumers, they will likely pay more for banking services. The President of the Sao Paulo Federation of Industries (FIESP) Paulo Skaf told Econ-Pol Chief that the additional three percentage points would hit the working class hardest because they use the Brazilian equivalent of a pay advance called the "cheque especial" that carries higher interest rates (Ref B). He expects half of the estimated R$15 billion the GOB collects this year from IOF would come from the working class.

## Industry Reaction

¶8. (SBU) Industry largely disapproved of the GOB's measures. Skaf said that the measures are unnecessary and that the GOB should have used the opportunity of strong economic growth to stimulate credit. He opined that the Senate's rejection of CPMF reflected the "voice of the people" and that FIESP's efforts to end CPMF were based on the expectation that the GOB would not need additional revenue to cover the loss due to higher economic growth. When Econ-Pol Chief pointed out Minister Mantega's points regarding the need to raise the IOF to combat slowly rising inflation, Skaf stated that Mantega's position had little basis in reality and was merely his attempt to give an explanation to an unnecessary tax hike.

¶9. (U) Other industry interlocutors offered various opinions of the GOB response to the loss of the CPMF. Armando Monteiro, President of the Brazilian National Confederation of Industries, told O Globo television that he expects the tax hikes to mean higher interest rates and bank spreads; however, he approved of the GOB's announcement to cut expenditures. The senior advisor for the Commercial Association of Sao Paulo Sergio Leopoldo told Econ Specialist that the GOB should stimulate consumption to boost revenues, rather than dampen credit. He believes consumers will suffer the brunt of the hikes. The Economic Director for the Federation of Commerce (Fecomercio) Fernanda Rosa told Econ Specialist that Fecomercio estimated a two percent reduction in retail and service sales revenues and she said that the IOF increase punishes those who need financing for consumption.

## Spending Cuts in February?

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¶10. (SBU) The big uncertainty of the GOB's package of measures to fill the CPMF gap is spending cuts. The bright spot in the GOB's announcements in December after its failed attempt to extend the CPMF (Ref A) was the GOB's announcement that it would cut expenditure growth for the first time since

¶2003. The GOB again pledged in its package announced January 2 to cut R$20 billion across the legislative, executive, and judicial branches, but held off announcing specific cuts until February when Congress reconvenes and begins its review of the 2008 budget. For the most part, financial analysts are optimistic but remain unconvinced until the GOB releases more details. Nilson Teixeira, Managing Director for Emerging Markets Research at Credit Suisse, expects the GOB's will not meet the spending reduction mark, which they



estimate at 0.7 percent of GDP, which could force the GOB to reduce the primary fiscal surplus. However, if the economy grows as expected, the GOB should maintain its primary surplus target. According to Bear Stearns Economist Emy Shayo, she expects that the spending cuts will come in the form of lower wage hikes for civil servants and lower levels of investment spending. Oreng agreed that a likely option would be a freeze on public sector salary increases initially announced in 2007. End Comment.)

¶11. (SBU) Expected robust economic growth in 2008 may protect the GOB from needing to make significant spending cuts. Economic growth of five percent or more in 2008 would have covered the lost tax revenues from the CPMF, according to economic interlocutors. Skaf told Econ-Pol Chief that FIESP deemed a tax hike unnecessary because FIESP estimated a 12 percent increase in tax collection based on the projected economic growth of five percent, which easily would have covered the R$40 billion gap. Oreng told Econoff that Itau estimated an additional R$40 billion in tax collection from these two measures based on economic growth of five percent and far exceeds the GOB's estimate of R$10 billion. Likewise, Teixeira told Econoff that Credit Suisse believes that the government should collect more tax revenues under the two measures than estimated.

Legal Challenges Ahead?
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¶12. (U) The GOB's two tax measures may face legal challenges under the Brazilian Constitution. Opposition congressmen have initiated an inquiry into the GOB's decree and specialists including Mailson da Nobrega, former Finance Minister, say the IOF was not designed nor constitutionally mandated to be a revenue generating mechanism, as the GOB's decree explicitly intends it to be used. Under the Constitution of 1988, the IOF is restricted to credit and exchange regulation for use in inflation or balance of payments crises. Local press criticized the increase of the CSLL for similar legal irregularities. In addition, a Constitutional Amendment from 2003 prohibits the GOB from using provisional measures to assign differentiated tax rates. Press reports indicate that some law firms are encouraging their financial institution clients to fight the increase to the CSLL as discriminatory against their industry. Oreng, for his part, told Econoff that he doesn't expect the financial sector to submit claims and assumes they will pass on the additional tax to consumers.

¶13. (SBU) COMMENT: The IOF and CSLL tax increases are likely to dampen the rapid rate of credit growth in Brazil, but are unlikely to change the prospects for continued credit expansion this year on the order of 20 percent in Brazil. The increase in the cost of credit should help soothe the Central Bank's fears that the Brazilian economy is beginning to overheat. From a macroeconomic perspective, the GOB's rhetoric to cut spending is a positive sign; however, Post remains unconvinced that the GOB will successful trim

spending by R$20 billion. The risk exists, though minimal, that the GOB may eat into the primary surplus despite the GOB's repeated statements to the contrary. The primary surplus has been the GOB's key policy anchor since 2003 and any adjustment would represent a change in policy and would have implications for Brazil's fiscal accounts. Furthermore, covering the CPMF revenue gap has distracted the GOB from working on ways to tackle the growing inflation problem.



Brazil closed out 2007 with inflation nearly two percentage points higher than at the end of 2006 and runs the risk that the Central Bank will decide to raise interest rates. The political ramifications of the GOB's announcement, however, are the most disconcerting. The Lula Administration backtracked on a deal it made with the opposition in order to get the de-earmarking measure (DRU) passed in December (Ref A). In doing so, the GOB has likely closed off any remaining possibility for working with the opposition to institute a comprehensive tax reform, as some analysts hoped following the CPMF defeat. END COMMENT.

¶14. (U) This cable has been coordinated with the U.S. Treasury Attache in Sao Paulo and Embassy Brasilia.
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